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### USING THE RHODE ISLAND HISTORIC PRESERVATION INVESTMENT TAX CREDIT: CLARIFICATIONS FROM THE TAX DIVISION PROVIDE PRACTICAL GUIDANCE

During the 2000-2001 legislative session, the Rhode Island General Assembly enacted a new state historic tax credit law (the "State Historic Investment Tax Credit Act") with an effective date of January 1, 2002 (the "Effective Date"). The State Historic Investment Tax Credit Act provides for a credit (the "Rhode Island Historic Investment Tax Credit" or the "Credit") against Rhode Island income tax equal to thirty percent (30%) of the "qualified rehabilitation expenditures" expended for the "substantial rehabilitation" of a "certified historic structure", provided the rehabilitation meets standards consistent with United States Department of the Interior standards for the federal historic tax credit (the "Federal Historic Tax Credit") available under Section 47 of the Internal Revenue Code of 1986, as amended (the "Code"). The Credit is available to offset personal income tax, as well as income tax payable by corporations, banks, insurance companies, and public service corporations.

The Rhode Island Historical Preservation and Heritage Commission (the "Commission") has adopted regulations (the "Regulations") regarding procedures for using the Rhode Island Historic Investment Tax Credit. The Regulations are available on the Commission's website at [www.preservation.ri.gov](http://www.preservation.ri.gov).

The Tax Division of the State of Rhode Island Department of Administration (the "Tax Division") has recently issued guidance that resolves some uncertainties regarding the Tax Division's interpretation of the State Historic Investment Tax Credit Act. The Tax Division's guidance on specific

issues is discussed where appropriate in this article. In addition, the Tax Division has indicated that terms used in the State Historic Investment Tax Credit Act have the same meaning as when used in a comparable context under federal income tax law, unless a different meaning is clearly required. This position is consistent with the principles enunciated in R.I. Gen. Laws 1956 (1999 Reenactment) Section 44-30-6, and will be a useful guiding principle as the Credit begins to be implemented in a variety of types of transactions.

## **I. Requirements for Qualification of the Building and the Rehabilitation**

### **1. Certified Historic Structure**

In order to qualify for the Rhode Island Historic Investment Tax Credit, a building must be a “certified historic structure”. For purposes of the Act, a “certified historic structure” (a “Certified Historic Structure”) is one that (i) is listed individually in either the National Register of Historic Places or the State Register of Historic Places, or (ii) is located in a registered historic district and certified by either the United States Secretary of the Interior or the Commission as being of historic significance to the district.

### **2. Certified Rehabilitation**

In order to qualify as a certified rehabilitation (a “Certified Rehabilitation”), the rehabilitation of a Certified Historic Structure must be consistent with the historic character of the property or the district within which it is located, as determined by the Commission. Taxpayers who desire to take advantage of the Credit must apply to the Commission before the building is placed in service for approval of the planned rehabilitation, which must be consistent with the United States Department of the Interior’s standards. A rehabilitation that has received Part 1 and Part 2 approval from the National Park Service for purposes of the Federal Historic Tax Credit will generally qualify for purposes of the Rhode Island Historic Preservation Investment Tax Credit; however, an applicant is required to file Parts 1 and 2 of the Rhode Island application in addition to the federal application. Upon completion of the rehabilitation, the taxpayer must again apply to the Commission for confirmation that the completed work is consistent with the United States Department of the Interior’s standards, using Part 3 of the Rhode Island application. The Commission must respond to the latter application within 90 days, and if it approves the Rehabilitation, it will issue a Certificate of Completed Work for the project.

### 3. Qualified Rehabilitation Expenditures

Only “qualified rehabilitation expenditures” (“QREs”) are eligible for the Rhode Island Historic Investment Tax Credit. QREs include amounts incurred in connection with a Certified Rehabilitation that are capitalized to the building and either (i) depreciable under the Code or (ii) made with respect to property (other than the principal residence of the owner) held for sale by the owner.

Under the Regulations, amounts are properly capitalized to the building if they are properly includible in computing the depreciable basis of real property under federal income tax law. Amounts treated as an expense and deducted in the year paid or incurred or amounts that are otherwise not added to the basis of real property do not qualify. Amounts incurred for soft costs, including without limitation architectural and engineering fees, survey fees, legal expenses, insurance premiums, development fees and other construction-related costs that are added to the depreciable basis of real property do qualify.

Examples of expenses that do not qualify as QREs include:

- The cost of acquiring a building, an interest in a building (including a leasehold interest) or land.
- Any expense attributable to enlargement of a building.
- Any expense attributable to the rehabilitation of a Certified Historic Structure, or a building located in a Registered Historic District that does not qualify as a Certified Rehabilitation.
- Except in the case of a non-profit entity, costs that are funded by a direct grant made by a federal, state, or local governmental source.
- Site work, such as utilities outside the building footprint, parking lots, or landscaping.

The Tax Division has stated that it will accept the definition of QREs set forth in the Regulations.

When QREs are incurred with respect to a building by a prior owner, and a new owner acquires the building or a portion of the building (including a leasehold interest therein) to which the expenditures were allocable, the new owner acquiring such property will be treated as having incurred the QREs actually incurred by the prior owner, provided that (i) the Rehabilitation was not placed in service by prior owner and (ii) no Credit with respect to such QREs is claimed by anyone other than the taxpayer acquiring the property or that taxpayer’s assignee(s).

Like the Federal Historic Tax Credit, the Rhode Island Historic Investment Tax Credit is available for rehabilitation expenses that are depreciable. Unlike the Federal Historic Tax Credit, the Rhode Island Historic Investment Tax Credit is also available for rehabilitation expenses made with respect to property (other than the principal residence of the owner) held for sale by the owner. Thus, developers of commercial or residential property can qualify for the credit, as can developers of commercial or residential condominium units to be held for sale.

#### 4. Substantial Rehabilitation

Only rehabilitation projects that meet a “substantiality test” qualify for the Rhode Island Historic Investment Tax Credit. For this purpose, a rehabilitation is substantial if the QREs incurred during any 24-month period (the “Measuring Period”) selected by the owner and ending with or within the taxable year exceed fifty percent (50%) of the adjusted basis of the building and its structural components as of the beginning of such period (the “Minimum Expenditures Threshold”). For phased rehabilitations contemplated in architectural plans and specifications prior to the commencement of rehabilitation, the Measuring Period is extended to 60 months.

Where a qualifying building is acquired by a new owner from a prior owner who incurred QREs prior to the transfer, the Measuring Period during which the Substantial Rehabilitation Test must be met includes the transferor’s period of ownership, and the adjusted basis against which QREs are tested is the adjusted basis of the transferor as of the beginning of the Measuring Period.

#### 5. Timing Issues

The Rhode Island Historic Investment Tax Credit is claimed in the taxable year in which the Certified Historic Structure or an identifiable portion thereof is placed in service, provided that the Minimum Expenditure Threshold is met for that year. As more fully described below, the Credit is claimed by attaching a certificate issued by the Commission to the taxpayer’s Rhode Island income tax return. The Tax Division has indicated that the Credit will be considered claimed upon the filing of a tax return claiming the Credit. In the case of an extended return, the Tax Division has stated that the Credit will be considered claimed on the extended due date of the return or the date the return is actually filed, whichever occurs first.

Special rules apply to projects commenced before the Credit became law. Projects involving work commenced prior to the Effective Date may include QREs incurred prior to the Effective Date but no earlier than January 1, 2000, provided the Project is placed in service after the Effective Date. QREs incurred prior to the Effective Date but no earlier than January 1, 2000 also may be

included in determining if the Minimum Expenditures Threshold has been met, provided the project is placed in service after the Effective Date.

6. Credit Carryforward

For taxpayers who cannot take advantage of the full Credit in the year when the project is placed in service, the Rhode Island Historic Investment Tax Credit may be carried forward to offset future tax liability for up to ten years. The Tax Division has confirmed that the credit can be used in any year of the carryover period.

**II. Who Can Use the Rhode Island Historic Tax Credit?**

1. Eligible Taxpayers

As noted above, the Rhode Island Historic Investment Tax Credit may be claimed as a credit against Rhode Island income tax or similar taxes payable by individuals, corporations, banks, insurance companies, and public service corporations. Eligible taxpayers include “any person, firm, partnership, trust, limited liability company (whether for-profit or non-profit) or any other business entity.” In the case of a corporation, the Credit is only allowed against the tax of a corporation included in a consolidated return that qualifies for the Credit and not against the tax of other corporations that may join in the filing of a consolidated return.

2. Who Incurred the QREs?

The person entitled to claim the Rhode Island Historic Tax Credit is the person who incurred the QREs. As such, the Credit may be claimed by an owner of the fee interest of the building in question or by a lessee who incurs the QREs. In either case, however, the Substantial Rehabilitation Test must be met with respect to the entire Certified Historic Structure. Accordingly, the Commission will require a certification from the building owner as to the building’s adjusted basis, even if the QREs will be incurred by a lessee.

3. Non-Profit Developers

It should be noted that non-profit corporations are eligible for the Rhode Island Historic Investment Tax Credit. Because a tax-exempt non-profit corporation generally has no income tax liability, it will not be able to “use” the Credit in most circumstances. However, because the Credit is assignable, a non-profit developer could assign a Credit to which it becomes entitled to a Rhode Island taxpayer who can offset the Credit against its Rhode Island income tax liability. The non-profit developer can use the proceeds of sale of the Credit to finance the development that generated the Credit. The sales proceeds will be

taxable under federal income tax law, but are exempt from taxation in Rhode Island.

#### 4. Pass-Through Entities

The statute provides that the Rhode Island Historic Investment Tax Credit may be allocated among the owners of a partnership, limited liability company, S-corporation or other pass-through entity (a "Pass-Through Entity"), either pro rata or pursuant to an agreement among such parties, regardless of how other tax or economic attributes of the ownership entity are allocated. It should be noted, however, that there are a variety of federal tax issues to contend with in passing through the Credit to the owners of a Pass-Through Entity, particularly if federal income tax items are allocated differently.

If a Pass-Through Entity incurred the QREs, the Commission currently plans to issue Assignable Historic Preservation Investment Tax Credit Certificates to each owner of the Pass-Through Entity in the amounts specified by the applicant Pass-Through Entity. This is important, because each owner must attach an original Certificate to his Rhode Island income tax return in order to claim the Credit.

The Tax Division has indicated that in the case of a partnership, the Credit will be allocable to partners of record as of the end of the year in which the project qualifies for the Credit.

The Tax Division has also made clear that allocation of the Credit among the owners of multi-tier Pass-Through Entities will be made in a manner consistent with general partnership allocation principals. Thus, the Credit may be allocated to the partners at the first level in a multi-tier Pass-Through Entity structure and then again at the second level and onward through any number of Pass-Through Entities that are part of the multi-tier structure. This is an important concept because the Tax Division's position is that the Credit may be assigned (as opposed to allocated among partners) only once, as more fully discussed below.

The Tax Division has also stated that it will honor a "buyout" provision in a Pass-Through Entity's governing documents, where the interest of an owner entitled to the credit maybe subject to a put or call option.

### **III. How to Claim the Credit**

In order to claim the Credit, a taxpayer must attach an original Assignable Historic Preservation Investment Tax Credit Certificate to its Rhode Island income tax return for the year in which the Certified Rehabilitation is placed in service (provided that the Substantial Rehabilitation Test has been met). The taxpayer must apply for the Certificate upon completion of the

rehabilitation, and must include with its application a certificate of a Rhode Island-licensed certified public accountant confirming the amount of QREs incurred and the satisfaction of the Substantial Rehabilitation Test. The Tax Division has stated that the cost certification must comply with AICPA standards. The Commission will rely on the accountant's certification without independent investigation in determining the amount of Credit allocable to a particular project.

The Tax Division has stated that it will accept the Commission's certification as to the amount of QREs approved and the satisfaction of the Substantial Rehabilitation Test, provided the Commission's standards are consistent with the United States Department of the Interior Standards and the requirements of the State Historic Investment Tax Credit Act. It is expected that most developers will apply simultaneously for a Certificate of Completed Work and an Assignable Historic Preservation Investment Tax Credit Certificate.

#### **IV. Transfer of the Credit**

Unlike many other types of income tax credit, the Rhode Island Historic Investment Tax Credit may be assigned to "any individual or entity" separately from any interest in the real estate project that gave rise to the Credit. Thus, the Credit may be sold to a person without admitting that person to a Pass-Through Entity that owns the real estate. However, the Credit may be transferred only if the assignor has not claimed the Credit in whole or in part. In addition, the Tax Division's position is that the Credit may be assigned only once. Thus, although the taxpayer who incurred the QREs may assign the Credit to which he is entitled to one or more initial assignees, none of the assignees may further assign the Credit.

The State Historic Investment Tax Credit Act provides that any assignment or sales proceeds received for the assignment or sale of a Rhode Island Historic Investment Tax Credit will be exempt from Rhode Island income tax. However, proceeds from such sale received by the seller will be subject to federal income taxation. It should also be noted that if an assigned Credit is recaptured, there will be a corresponding adjustment in the seller's tax liability. The seller's tax calculation for the year of recapture will be increased by the amount of the sales proceeds received by it that was previously exempt from tax.

In order to perfect the assignment of the Credit, the assignor must file a notification with the Rhode Island Division of Taxation within 30 days after the transfer. The notification must contain the name, address, and taxpayer identification number or social security number of the assignor and assignee, together with other information required by the Division of Taxation.

Assignees of the Credit claim the Credit by attaching the Certificate to their Rhode Island income tax return for the year in which the project is placed in service, and may also carry the Credit forward for up to ten years.

Although in most instances it is expected that a transfer of the Credit will involve a payment to the assignor, the Tax Division has confirmed that the Credit may also be assigned for no consideration.

#### **V. Limitations on Use of the Rhode Island Historic Investment Tax Credit**

Taxpayers who claim the Credit in connection with a project are ineligible for tax credits that may be available under Rhode Island General Laws Chapter 42-64.7 (the mill building credit), Chapter 44-33.1 (the residential historic credit) and/or Chapter 44-31 (the investment tax credit) for the same project.

The Credit may not be used in connection with property that is exempt from real property taxation under Section 44-3-3 of the Rhode Island General Laws. However, properties subject to PILOT payments, tax stabilization agreements, or other types of tax abatements that do not result in a complete exemption from real property tax, and any property exempt under a provision other than Section 44-3-3, are not covered by the prohibition on combining the Rhode Island Historic Investment Tax Credit with exemption from real property tax.

#### **VI. Enforcement and Recapture**

As a condition to recognition of the Rhode Island Historic Investment Tax Credit, the owner of the property that generates the Credit must grant a restrictive covenant (the “Restrictive Covenant”) to the Commission providing that no alterations may be made to the building for a 24-month holding period without the Commission’s approval, and then only if they are in a manner consistent with the United States Department of the Interior’s Standards for Rehabilitation. If the person incurring the QREs is not the owner, the owner must execute the Restrictive Covenant. A draft of the Restrictive Covenant must be submitted to the Commission with the application for a Certificate of Completed Work (Part 3), and, upon approval, must be recorded before the Commission will issue an Assignable Historic Preservation Investment Tax Credit Certificate. The form of Restrictive Covenant is available from the Commission.

There is only one express recapture provision in the statute. If the property becomes exempt from real property taxation under Section 44-3-3 of the Rhode Island General Laws during a 24-month holding period (the “Holding Period”) after the issuance of a certificate of computed work, the entire Rhode



Island Historic Investment Tax Credit is recaptured. It is expected that a prohibition on the property becoming exempt from real property tax under Section 44-3-3 during the restriction period will be included in the Restrictive Covenant. As previously noted, if the Credit has been assigned to a third party, recapture will also trigger an adjustment to the Rhode Island income tax of the assignor of the Credit.

If information comes to the attention of the Commission at any time up to and including the last day of the Holding Period that is materially inconsistent with a representation made to the Commission in an application, the Commission may deny the requested certification or revoke a certification previously given. The Rhode Island Tax Administrator also has statutory authority to examine records, examine persons claiming the Credit, and to request information from the Commission to ascertain the correctness of any Credit claimed under the Act.

## **VII. Structuring Transactions with the Rhode Island Historic Investment Tax Credit**

There are many ways to structure transactions that generate the Rhode Island Historic Investment Tax Credit. A developer who simply assigns the Credit to a third party purchaser will pay federal (but not state) income tax on the sales proceeds, but will otherwise enjoy a fairly straightforward transaction. The same developer could develop the project through a Pass-Through Entity and grant an investor an ownership interest in the entity that includes an allocation of the Rhode Island Historic Investment Tax Credit. In this case the investor will make a capital contribution to the Pass-Through Entity that, assuming that there are no other federal income tax issues created by the particular structure of the transaction, should not be treated as income to the Pass-Through Entity. Projects that generate federal tax benefits, such as the Federal Historic Tax Credit or the low-income housing tax credit under Section 42 of the Code in addition to the Credit, will need to use the Pass-Through Entity structure to achieve the desired federal benefits. The structuring issues for projects involving a mix of federal and state credits become very complex, especially if there are separate investor groups, one of which has an appetite only for the federal tax benefits with the other seeking only the State Credit. In order to avoid unexpected pitfalls, developers should seek legal and accounting advice in structuring any transaction involving the Rhode Island Historic Investment Tax Credit.